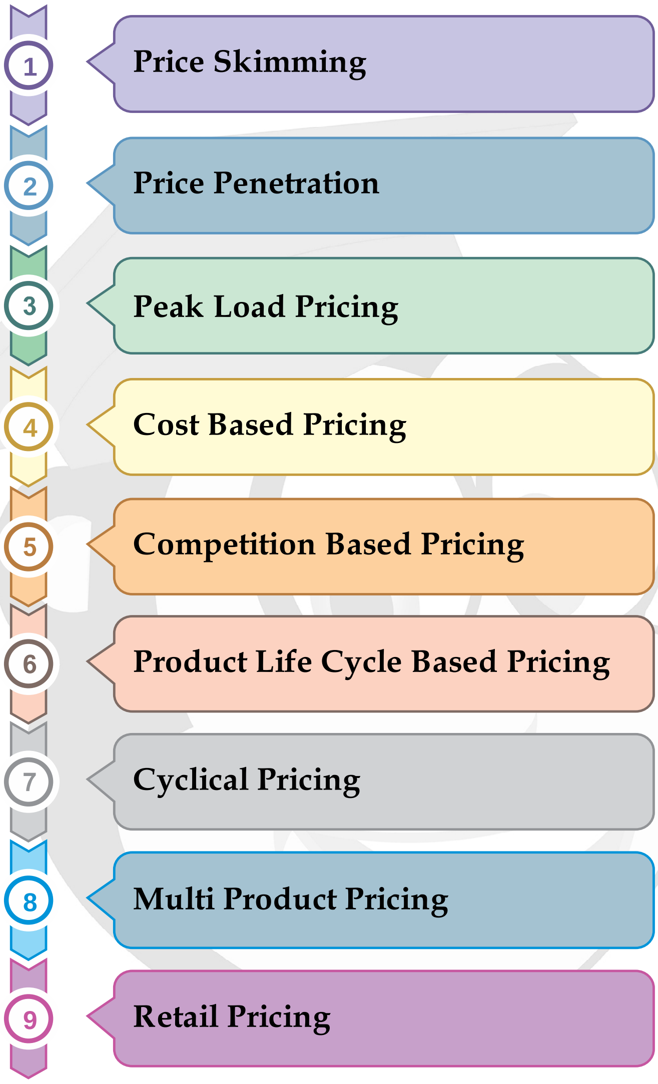
11. Pricing Strategies

Pricing theory based on the profit maximization hypothesis. Pricing theory under this hypothesis suggest that given the demand and cost curve price and output are so determined that profit maximized at the level of output are so determined that profit maximized. Pricing is one of the most important elements in economics. There are a number of pricing strategies which are discussed as under.



(A) Price Skimming : *The pricing strategy in which Setting a high price for a new product to capitalize on high demand so as to skim the cream from the market, is known as Skimming pricing.* Skimming pricing is used when a product, which is new in the market or just launched, is sold at a relatively high price because of its innovative product.

Price Skimming is usually used by a First Mover who faces little to no competition. Price skimming is not a viable long-term pricing strategy as competitors eventually launch rival products, and put pricing pressure on the first company.

The main objective of this strategy is to maximize potential profits until the optimum price is reached.

Graphically Explain

A skim strategy clearly exploits the downward sloping demand curve by sequentially targeting different market segments to maximize initial revenues, and is most appropriate when time is not of the essence (e.g. competition is not imminent) and futures-related benefits are minimal.

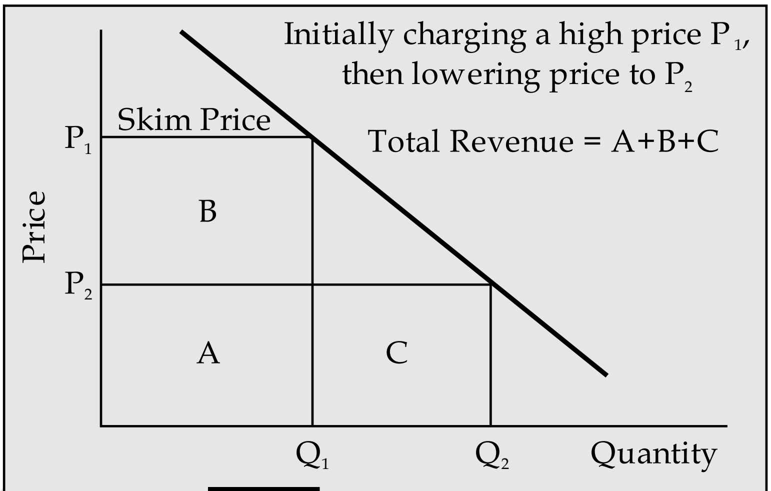


Fig. : Price Skimming

Conditions of Price Skimming

- The high introductory price can be charged only for unique products and the products for which easy substitutes are not available customers pay high price for the product for its novelty and uniqueness.
- If the product can be copied easily when price skimming will not bring revenue for a longer time.
- To use price skimming strategy there must be customers in the market who value the uniqueness of the product and are ready to pay high price.

The major benefits of this strategy are high profit margin, cost recovery, dealer's profit and quality image. Price skimming method has some limitations such as there is continual competitive pressure and cost inefficiency. Adopting this strategy enable to recover development cost through high profit margin.

(B) Price Penetration : *Penetration refers to using low price to* ***"penetrate"*** *the market and promote large sales shortly after the product launching. Price Penetration means using lower initial price to capture a large market.* These forces the customers to buy the product and company can capture a very big share and leave very small share for competitors.

It refers to a setting where initial price is lower than later as this type is focused on cost reduction over time and discouragement of competitors' entry.

The objective is to obtain a larger market share. This can be defined as the low-price strategy enriched by the time factor. Penetration pricing leads to cost reduction pressure and discourage the entry of competitors.

Penetration pricing is attractive when following conditions are satisfied :
- *The price elasticity of demand is high and easy substitutes of that product are available.*
- *The firm can increase its production capacity with increase in demand.*
- *When customers are highly price sensitive which means customers easily shift to another brand if it is available at low price.*
- *When company has to face high competition while launching the product.*

Penetration pricing strategy is one in which the company charges a low price, in the beginning, to derive maximum sales volume from the price-sensitive customers. On the contrary, when at the initial stage high prices are charged to the customers which is gradually decreased to attain maximum profit from less price sensitive customers.

Advantage of Penetration

- **Adoption and Diffusion :** *Diffusion is the process of acceptance of a new product or service by the consumers. Adoption is similar to diffusion here the focus is on the psychological acceptance of the product by the consumer.* Rate of diffusion or adoption is the speed at which it is accepted. Both adoption and diffusion rates are high when penetration policy is adopted.
- **Not much Competition in The Initial Phase :** When penetration pricing is introduced the competitors are caught unaware. Most importantly it leaves them with very little reaction time, so in the initial phase not much competition is faced.
- **Cost Efficiency :** The emphasis on keeping the price low helps in controlling the cost thereby cost efficiency is achieved.
- **Competitors are kept :** If a manufacturer adopts penetration pricing and lowers the price of his products or services he may stop competitors from entering the market. This happens because now the competitors will have to enter the market at lower than existing prices. This reduces their profit not to mention the risk they face as new entrants in acquiring market share.
- **Channel Benefit :** As this technique creates a quick turnover it keeps its retailers and distributors beneficial.

Disadvantage

- The customer expects the prices to remain low for a long term. They are not ready for the subsequent rise in the price and when it happens they might switch to a competitor's product. Thus subsequent price hike leads to loss of market share gained.
- It is believed that penetration pricing cannot create strong customer relationship and only attracts customers on the lookout for a profitable deal.

(C) Peak Load Pricing : *The basic peak-load pricing problem, pioneered by Marcel Boiteux (1922) considers two periods. Peak Load pricing also involves charging different point in time. The Peak Load Pricing is the pricing strategy wherein the high price is charged for the goods and services during times when their demand is at peak.* In other words, the high price charged during the high demand period is called as the peak load pricing.

It is an efficient means of pricing in which at the time of peak demand prices rise to balance to demand and supply. Most of our goods or services are limited in nature but its demand may vary depending upon various factors like season, income, price, etc. Electricity distribution companies use peak load pricing to maximize its revenue. During the day time when available electricity is more than the demand, the pricing is at its lowest point which will be enough to cover its marginal cost. For example Electricity distribution companies use peak load pricing to maximize its revenue. During the day time when available electricity is more than the demand, the pricing is at its lowest point which will be enough to cover its marginal cost.

Peak load pricing helps to maximize capacity utilization where resources are scarce. When demand is low price is charged in such a way that at least one can recover his marginal cost, and when the demand is high, price is equal to marginal cost plus additional premium charged to bring down the demand equal to supply.

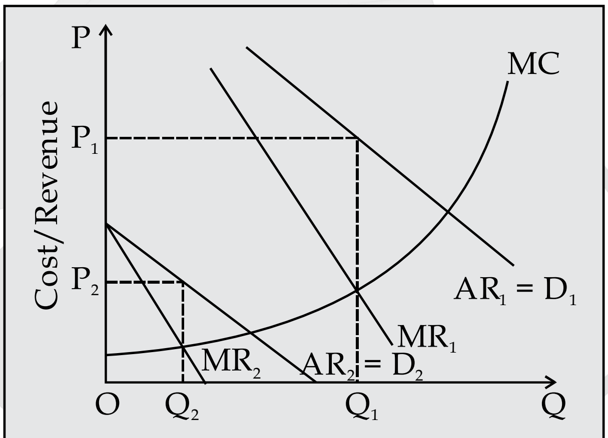


Fig. : Peak-Load Pricing

MC is also high during these peak periods because of capacity constraints. Prices should, thus, be higher during peak periods where D_1 is the demand curve for the peak period, and D_2 is the demand curve for non-peak period.

The firm sets MC = MR for each period, such that price P_1 is high for the peak period, and the price P_2 is lower for the off-peak period, with corresponding quantities Q_1 and Q_2. This increases the firm's profit above what it would be if it charged one price for all periods. It is also efficient; the sum of producer and consumer's surplus is greater because prices are closer to MC.

(D) Cost Based Pricing : *Under cost plus pricing, price of the product is the sum of cost plus a profit margin.*

(i) Cost Plus or Mark-up Pricing : It is a straight forward and effective strategy because it ensures that all costs are covered before profits are calculated. Full cost is full average cost which includes average direct costs (AVC) plus average overhead costs (AFC) plus a normal margin for profit :

P = AVC + AFC + profit margin or mark-up.

Thus the two elements of cost-plus price, one is the cost and the other one is mark-up. These two components are separately analyzed. Cost is an important factor in determining price. The cost is the base on which is grounded the percentage of profit. Costs carry main influence on price and are long-term price determinants are different methods of computing the cost.

(ii) Marginal Cost Pricing : This is used when demand is slack and market is highly competitive. *Under marginal cost pricing price of the product is the sum of variable cost plus a profit margin.* This method is used by firms to enter into a new market as well as to beat competitors. As this method ignores the element of fixed cost, it cannot be adopted as a long term strategy.

(iii) Target Return Pricing : This method of pricing is the same as the previous ones but for the fact that margin is decided on the basis of target rate of return, determined on the company's experience, consumer's paying capacity, risk involved, and similar other factors.

(E) Competition Based Pricing :

(i) Penetration Pricing : *When a firm plans to enter a new market which is dominated by existing players, its only option is to charge a low price, even lower than the ongoing price. This price is called Penetration price. The principle of marginal costing may be used to determine penetration price.* This method is short term in perspective and its success largely depends upon the price elasticity of demand of the product because in the long run ultimately factors other than price may become important.

(ii) Entry Deterring Pricing : *Under this method of pricing the price is kept low, thus making the market unattractive for other players.* Success of entry deterring pricing strategy depends on the fact that the firm earns economies of scale and hence can afford to charge low price. This practice is also known as Limit Pricing.

(iii) Going Rate Pricing : *Going rate pricing strategy is adopted when most of the players do not indulge in separate pricing but follow the prevailing market price.* This pricing strategy is popular in monopolistic and oligopoly markets where product differentiation is minimal or only cosmetic, and consumer's switching cost is almost negligible. It is mostly adopted when the product has reached maturity and has become generic to the extent that consumers ask for a good soap or soft tooth brush instead of a particular brand.

(F) Product Life Cycle Based Pricing : Product life cycle pricing refers to different pricing for a product at different stages of its life cycle (viz. introduction, growth, maturity, saturation, and decline).

(i) **Introduction :** *This is the first stage in the life cycle of a product. The product is a new one. The product is put on the market, awareness and acceptance are minimal.* There are high promotional costs. Therefore, the profit may be low. The firm can use two types of pricing policy, i.e., skimming price policy or centralizing price policy in this stage.

(ii) **Growth :** *In this stage, a product gains acceptance on the part of consumers and businessmen.* The product begins to make rapid sales gains because of the cumulative effects of introductory promotion, distribution work or mouth influence. The product satisfies the market. For the purpose of pricing, there is not much difference between growth and maturity stages.'

(iii) **Maturity :** *At this stage, keen competition increases. Sales growth continues, but at a diminishing rate, because of the declining number of potential customers.* Competitors go for mark-down price. Additional expenses are involved in the product's modification and improvement, thus profit margin slips. This period is useful because it gives out signals for taking precaution in pricing policy.

(iv) Saturation : *In this stage, the sales are at the peak and further increase is not possible. The demand for the product is stable. The rise and fall of sale depend upon supply and demand.* There is little additional demand to be stimulated, it happens to be its replacement demand. Therefore, the product pricing in the saturation stage is full cost plus normal mark-up.

(v) Decline : *Sales begin to diminish absolutely as the customers begin to tire of a product. The competitors have entered the market with substitutes and imitations.* Price becomes the competitive weapon. The product should be reformulated to suit the consumer's preferences; it is possible in the case of few commodities.

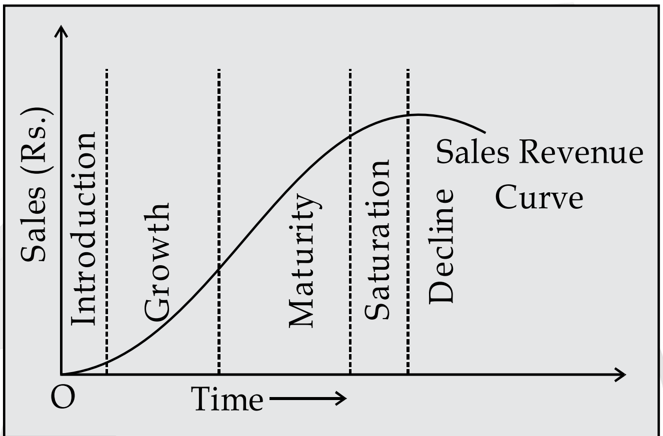


Fig. : Product Life Cycle

(G) Cyclical Pricing : *Cyclical pricing refers to the pricing decisions of the firm which are taken to suit the fluctuations in the business conditions.* To simplify decision making in response to the alterations in the entire economic system, it is necessary for the firm to have some kind of policy based on cyclical price behavior. It is more apparent to say that prices are slashed during recession and pegged up during a demand-pull or a demand-push.

In formulating a policy of cyclical pricing, various factors such as demand, competition, cost- push, price rigidity, price fluctuations, fluctuations due to substitutes, purchasing power, market share and demand fluctuation should be taken into account.

(i) Rigid Pricing : *Rigid pricing suggests that firms should follow a stable pricing policy irrespective of the phase of the economic cycle (i.e. inflation and recession)*

(ii) Flexible Pricing : *Under flexible pricing firms keep their prices flexible to meet the challenges of change in demand.*

(H) Multi Product Pricing :

(i) Loss Leader Pricing : *Under loss leader pricing multi product firms sell one product at a low price and compensate the loss by other products.*

(ii) Transfer Pricing : *Transfer prices are the charges made when a company supplies goods, services or financials to its subsidiary or sister concern.* Transfer pricing is used in large organizations for transaction between various divisions, i.e., internal pricing as opposed to external market.

(I) Retail Pricing :

(i) **Every Day Low Pricing (EDLP) :** *Under EDLP a low price is charged throughout the year and none or very few special discounts are given on special occasions.* This method can be successful only when the retailer is very large in size to avail of economies of scale and has very low overhead expenses.

(ii) **High-Low Pricing :** *This method involves high prices on a regular basis, coupled with temporary (or occasional) discounts as promotional activity.* On all days the price is higher than EDLP, but on discount days it is lower than EDLP. This method is adopted by those firms which have high overhead expenses and cannot afford everyday low pricing.

(iii) **Value Pricing :** *Under value pricing sellers try to create a high value of the product and charge a low price.* This is a strategy suitable for the maturity and saturation stage when demand can be maintained by keeping focus on higher quality and lower cost.

Ques. *For the following statements of Assertion (A) and Reasoning (R) indicate the correct code :*

Assertion (A) : *Price reduction normally leads to an increase in the demand for a commodity.*

Reason (R) : *Price reduction leads to the entry of new buyers of the commodity in the market.*

Codes : ***(NTA UGC-NET July 2016 P-II)***

(1) (A) is correct but (R) is not correct.

(2) (A) is not correct but (R) is correct.

(3) Both (A) and (R) are correct and (R) offers full explanation of (A).

(4) Both (A) and (R) are correct but (R) does not offer full explanation of (A).

Ans. *(4) Price reduction leads to increase in demand for a commodity, not only because new buyers, who were so far not having access to commodity due to low income, now enter the market, but also because the existing buyers too start using commodity for other purposed of less importance as it is now cheaper. For example when water is highly priced, one demands it only to drink then when its price drops, one can demand it for washing, cleaning and watering flowers too.*

Ques. *Product-line pricing strategy includes which combination of the following?*

I. Public utility pricing *II. Complementary goods pricing*

III. Spare parts pricing *IV. Load factor pricing*

Codes : ***(NTA UGC-NET July 2016 P-II)***

(1) I II III *(2) II III IV*

(3) I II IV *(4) I III IV*

Ans. *(2) Product-line pricing strategy includes combinations are of the following*

(ii) Complementary goods pricing

(iii) Spare parts pricing

(iv) Load factor pricing

Ques. ***Assertion (A) :*** *Differential pricing structure is designed to accommodate the various categories of buyers.*

Reason (R) : *It aims at increasing sales and revenues and driving the competitors out from the market.*

Codes : ***(NTA UGC-NET Dec. 2014 P-III)***

(A) *Assertion (A) and Reasoning (R) both are correct.*

(B) *Assertion (A) is correct, but Reasoning (R) is incorrect.*

(C) *Assertion (A) is incorrect, but Reasoning (R) is correct.*

(D) *Assertion (A) and Reasoning (R) both are incorrect.*

Ans. (B) *A differential pricing comes in different forms, from discounts for a particular group of people to coupons or rebates for a purchase. Offering discounts allows your company to expand to customers who might not otherwise buy your product. The company's overall sales increase due to this expanded customer base. In cases when strategies like coupons, sales or rebates are used, the initial discount gives the new customers a chance to try the product. If they like what they experience, they may continue buying the product at full price when the discount is no longer available. It does not drive competitors out of the market but is a way to increase sales.*

Key Points & Revision Summary

Meaning

Business Economics is the use of economics theories by the Management in Marking business decision."

Objectives of Business Firms

1. *Profit Maximization*
2. *Market Share*

Business Economics

1. *It is applied Economics.*
2. *Managerial economics applies economic theories and principles to solve the business problems.*
3. *Managerial economics relatively give more stress on micro economics than macro -economics.*
4. *It's microeconomic part considers only individual firm.*
5. *Micro Economic part of managerial Economics is related only with profit*

Scope of Business Economics

(A) *Operational or Internal Issues.*

(B) *Environmental or External Issues.*

Demand Analysis

- *The term demand implies a desire for a commodity backed by the ability and willingness to pay for it.*
- *Demand function is a function that describe how much of a commodity will be purchased at the prevailing prices of that commodity and related commodities, alternative income levels, and alternative values of other variables affecting demand.*
- *The demanded schedule is generally represented by a table which shows how quantity demanded of goods varies, the price and other things remain constant.*
- *Demand curve graphical representation of the demand schedule is the demand curve.*

Factor Affecting of Demand

1. *Price of the Commodity*
2. *Income of the Consumer*
3. *Prices of Related Goods*
4. *Tastes of the Consumers*
5. *Wealth*
6. *Population*
7. *Government Policy*
8. *Expectations Regarding The Future*
9. *Climate and Weather*
10. *State of Business*

Key Points & Revision Summary

Law of Demand

The law of demand expresses a relationship between the quantity demanded and its price. The law refers to the direction in which quantity demanded changes with a change in price.

- When there is decrease in price of commodity there is in increase in demand of that commodity. This is called extension of demand.
- When there is increase in price of a commodity there is decrease in the demand for that commodity. This called contraction of demand.

Elasticity of Demand

Elasticity of demand is the percentage changes in demand as a result of one per cent in the price of the commodity.

Concept of Price Elasticity of Demand

1. Price of Elasticity of Demand

$$e_d = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in price}}$$

$$\text{Price elasticity of demand } = \frac{\Delta Q / Q}{\Delta P / P}$$

Where Q = Original Quantity Demanded
P = Original Price
ΔQ = Change in Quantity = Demanded
and ΔP = Change in Price

2. Income Elasticity of Demand

$$E_y = \frac{\%\text{ change in quantity demanded of } A}{\%\text{ change in income}}$$

$$\text{Income elasticity of demanded} = \frac{\Delta Q / Q}{\Delta I / I}$$

3. Cross Elasticity of Demand

$$E_{A,B} = \frac{\%\text{ increase in quantity demand of } A}{\%\text{ increase in price of product } B}$$

Types of Elasticity of Demand

(i) Perfectly Elasticity of Demand ($ed = \infty$)
(ii) Highly Elasticity of Demand ($ed > 1$)
(iii) Unitary Elastic Demand ($ed = 1$)
(iv) Less Elastic Demand or Relatively Inelastic Demand ($ed < 1$)
(v) Perfectly Inelastic Demand ($ed = 0$)

Consumer Behaviour

Consumer behavior is about the behavior of consumers in different situations. The behavior that consumers display in searching for, purchasing, using, evaluating and disposing of products, services and ideas.

Key Points & Revision Summary

Utility

Utility is a psychological feeling of satisfaction, pleasure, happiness, or well- being which a customer derives from the consumption possession or the use of commodity. In economic theory utility can be measured in two ways.

- ***Cardinal Utility :*** *Propounded by Marshall which is known as Marshaling Approach.*
- ***Ordinal Utility :*** *Propounded by Hicks & Allen which is known as Indifference curve Analysis.*

Indifference Curve

An indifference curve is a curve which represents all those combinations of goods which give same satisfaction to the consumer.

Law of Variable Proportions

Law of Variable Proportions is also known as the Law of Diminishing Returns. This law is a generalization which the economists make about the nature of technology which makes possible to combine the same factors of production in a number of different proportions to make the same product.

Law of Returns to Scale

Returns to scale refers to relationship between in change output and proportionate change in all factors of production.

Three Types of Law of Returns to Scale :

1. *Increasing Returns to Scale*
2. *Constant Returns to Scale*
3. *Decreasing Returns to Scale*

Theory of Cost

Cost is 'measurement in monetary terms of the amount of resources used for the purpose of production of goods or rendering services.

Revenue

'The revenue of a firm is its sales, receipts or income'. The revenue concepts are concerned with Total Revenue, Average Revenue and Marginal Revenue.

- *Average revenue refers to revenue per unit of output sold. It is obtained by dividing the total revenue by the number of units sold.*
- *"The marginal revenue is the change in total revenue resulting from selling an additional unit of the commodity."*

Price Determination Under Different Market Forms

Market : *"The term market refers not necessarily to a place but always to a commodity and the buyers and sellers who are in direct competition with one another."*

Types of Market Structure

Perfect Competition - The Perfect

(a) Perfect Competition : *The Perfect Competition is a market structure where a large number of buyers and sellers are present, and all are engaged in the buying and selling of the homogeneous products at a single price prevailing in the market.*

Price-Output Determination under perfect competition There are two well-known approaches to pricing under perfect competition :

1. *Partial Equilibrium Approach*
2. *General Equilibrium Approach*

Key Points & Revision Summary

(b) Monopoly : *The word 'Monopoly' means "alone to sell". Monopoly is a market situation in which there is only one seller of a product with barriers to entry of others. Study of price and equilibrium determination under monopoly is conducted in two time periods.*

(i) Short Period and

(ii) Long Period

(c) Monopolistic : *Where degree of Competition is high but less than one the firm have some discretion in setting the price of their products. The monopolistic competition is also called as imperfect competition because this market structure lies between the pure monopoly and the pure competition.*

Monopolistic Price Discrimination

(a) Short Run Equilibrium

(b) Long Run Equilibrium

(d) Oligopoly : *The Oligopoly market structure lies between the pure monopoly and monopolistic competition, where few sellers dominate the market and have control over the price of the product.*

Price Discrimination of Oligopoly

1. *The Sweezy Model of Kinked Demand Curve (Rigid Prices)*
2. *Collusive Oligopoly*

Pricing Strategies

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- *Price Penetration means using lower initial price to capture a large market. These forces the customers to buy the product and company can capture a very big share and leave very small share for competitors.*
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